

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Alternative Investments-
Co-Investment Policy

ITEM NUMBER: 12

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: April 7, 1999

INFORMATION: _____

PRESENTER(S): Mr. Desrochers & Mr. Rose

EXECUTIVE SUMMARY

One of the 1998-99 Investment Branch objectives was to "Review and revise the policy for Co-Investments including the performance objective, target, and range."

In March 1999, staff and Pathway Capital Management conducted a presentation to discuss the benefits and detriments of co-investments and secondary interest investments. Policies for the Alternative Investment Program were presented for the Investment Committee's consideration. The Investment Committee suggested several modifications to the Alternative Investment Policy which have been incorporated as Attachment 1. Specifically policies 18 and 19 have been revised to reflect changes desired.

RECOMMENDATION:

Staff recommends Investment Committee approval of the Alternative Investment Policy by adopting the attached resolution (Attachment 2). Pathway Capital Management has reviewed the policies and concurs with the staff recommendation.

INTRODUCTION

In accordance with the Investment Management Plan, California State Teachers' Retirement System (CalSTRS) has a commitment to illiquid equity and equity related funds actively managed by specialized professionals to achieve a total rate of return superior to public equity vehicles.

The portfolio holding these assets is identified as Alternative Investments. This portfolio can include limited partnerships, direct investments, co-investments, and secondary interests in the following market segments:

- Leveraged Buyout
- Venture Capital
- Distressed Debt
- Mezzanine Financing
- Natural Resources

The primary objective for the alternative investment portfolio is to provide enhanced investment returns over those available in the public market. The increased risk associated with the structure, liquidity, and leverage requires a higher net total rate of return.

The CalSTRS Board established the asset allocation and strategic objectives for the alternative investment portfolio. The management of all types of investments is performed by internal and external professionals which are monitored and evaluated by internal investment officers and an external alternative investment consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external alternative investment consultant reports directly to the CalSTRS Board.

This manual will establish the policies and procedures involved in the management of investment of Alternative Investments. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies presented.

ALTERNATIVE INVESTMENT PROGRAM POLICIES

The following represent the approved policies to be utilized in the management of the alternative investment segment of the total investment portfolio. The policies are designed to set boundaries for the expected performance and structure. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board.

1. The alternative investment portfolio of the California State Teachers' Retirement System is invested in a prudent manner for the sole benefit of CalSTRS participants and beneficiaries in accordance with the Teachers' Retirement Law and other applicable statutes.
2. The alternative investment portfolio shall be invested to provide enhanced investment returns. Generating high rates of return shall always be the primary objective with diversification being an ancillary benefit. The alternative investment portfolio performance benchmark shall be the dollar weighted return for the Russell 3000 Index plus 5% - adjusted for the latest three years contributions at the 3-month T-bill return.
3. Diversification within the alternative investment portfolio is critical to control risk and maximize returns. The specific investments shall be aggregated, evaluated, and monitored to control unintended biases. Diversification can occur across the following parameters.
 - A. **Market Segment** -- The market segments are defined as Leveraged Buyout, Venture Capital, Distressed Debt, Mezzanine Financing, and Natural Resources.
 - B. **Vintage Group** -- Vintage group is defined by the closing date of the limited partnership. Investments within market segments shall be stratified by vintage group to mitigate the impact of fund flow trends within each segment.
 - C. **Economic Sector** -- Economic sectors are described by the standard Value-Line categories such as finance, technology, medical health, or electronic.
 - D. **Geographic Location** -- Geographic regions are defined as the location of the head office of the company. The geographic breakdown is expressed as West Coast, Southwest/Rockies, Southeast, Northeast, Mid-West, Mid-Atlantic, United Kingdom, Europe, Canada, and Other International.

Investments shall not be approved for the sole purpose of aligning one specific diversification range. Projected rate of return, risk, and other policies shall receive consideration in addition to diversification.

4. A strategic target and range shall be established for the market segment criteria. The target and range may change over time as conditions warrant as approved by the Investment Committee. The target and range criteria are included as Exhibit 1. The

diversification criteria will be reviewed on an annual basis.

5. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the alternative investment portfolio.
6. Authorization letters which indicate who may sign on behalf of CalSTRS shall be included at the time of closing. Whenever a change in authorized signers take place, the limited partnerships shall be notified in writing within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer(s).
7. Prior to being processed by the Operations Area, all cash contribution and stock sales transaction tickets shall be signed by two Investment Officers.
8. Graduated limitations of daily trading authority for aggregate alternative investment portfolio transactions are as follows:

Associate Investment Officer	\$ 1 million
Investment Officer I	\$ 5 million
Investment Officer II	\$ 10 million
Investment Officer III	\$ 20 million
Principal Investment Officer	\$ 35 million
Director of Alternative Investments	\$ 50 million
Chief Investment Officer	\$200 million

9. The alternative investment portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
10. The alternative investment consultant will prepare and present a portfolio management report on a semi-annual basis. The management report will provide portfolio diversification, largest holdings, common holdings, partnership performance, co-investment holdings, and committed and funded status.
11. The rejection decision for limited partnerships, direct investments, co-investments, and secondary interests is delegated to staff with the stipulation that all investment opportunities receive equal opportunity and subject to the appropriate amount of due diligence as defined in the alternative investment procedures.

PARTNERSHIP INVESTMENTS

12. The approval decision under delegation as it relates to new limited partnerships, follow-on limited partnerships, shall be completed following a positive written recommendation by

the alternative investment advisor and CalSTRS' staff. The investment analysis and due diligence will be conducted in the same manner as previously reviewed by the Investment Committee.

13. The approval decision for “follow-on limited partnerships” is delegated to staff considering the following stipulations:
 - A. Applicable only to limited partnerships sponsored by general partner(s) included in the CalSTRS' alternative investment portfolio.
 - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - C. Maximum amount of the commitment shall not exceed \$400 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
14. The approval decision for “new limited partnerships” is delegated to staff considering the following stipulations:
 - A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - B. Maximum amount of the commitment shall not exceed \$100 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.

SECONDARY PARTNERSHIPS

15. The approval decision under delegation as it relates to secondary partnerships shall be completed following a positive written recommendation by the alternative investment advisor and the CalSTRS staff. The investment analysis and due diligence will be conducted in-the same manner as previously reviewed by the Investment Committee.
16. The approval decision for “secondary limited partnership” interests is delegated to staff considering the following stipulations:
 - A. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - B. Maximum amount of the commitment shall not exceed \$100 million or 20% of the total amount of the partnership capitalization, whichever is less.
 - C. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
 - D. Secondary partnership investments may be made in partnerships in which CalSTRS is not a limited partner.

CO-INVESTMENTS

17. The approval decision under delegation as it relates to co-investments shall be completed following a positive written recommendation by the CalSTRS staff and either 1) an alternative investment advisor, or 2) an independent fiduciary. The investment analysis and due diligence will be conducted by the CalSTRS staff (as identified in the Alternative Investment Procedures) and by the above external entity. CalSTRS staff and the above external entity must each provide a position written recommendation.
18. The approval decision for co-investments is delegated to staff considering the following stipulations:
 - A. Co-investments shall be made on the same (or better) terms and conditions as provided to the partnership.
 - B. Due diligence process shall be consistent and appropriate as defined in the alternative investment procedures.
 - C. Maximum amount of the each commitment shall not exceed \$75 million or 30% of the CalSTRS commitment to that partnership, whichever is less.
 - D. A final report will be presented to the Investment Committee as soon as practical after the commitment is completed.
 - E. Co-investments are limited to the United States, Canada, the United Kingdom, and Continental Europe. (The business activities of the co-investment must be primarily in these countries).
 - F. A co-investment may take the form of equity, convertible preferred equity or a comparable instrument which provides an equity type of return.

March 3, 1999 alternative investment presentation to the Investment Committee, in addition to Alternative Investment procedures, glossary of terms, and desk manual, are incorporated into this policy by reference.

Adopted June 1998
Revised July 1998
Revised April 1999

California State Teachers' Retirement System			
Alternative Investments - Allocations and Targets			
Alternative Investments sub-category	Approved ranges	Approved targets	Market Value
Buy-out	50-70%	60%	61%
Venture capital	10-20%	16%	16%
Debt related	0-10%	2%	11%
Equity expansion	5-15%	7%	5%
International Buy-Out	10-20%	15%	7%
Total		100%	100%

Attachment 2
Investment Committee – Item 12
April 7, 1999

**PROPOSED
RESOLUTION OF THE
CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE**

Subject: Alternative Investment Policy

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Alternative Investment Program Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff and Pathway Capital Management have recommended the adoption of the Alternative Investment Program Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Alternative Investment Program Policies.

Adopted by:
Investment Committee
On April 7, 1999

James D. Mosman
Chief Executive Officer